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The global credit boom that resulted from the U.S. current account deficit caused worldwide over-investment and over-consumption as well as asset price bubbles. While credit-induced consumption temporarily absorbed the expanding capacity, an inflection point has now been reached. Over-investment has created tremendous excess capacity that is resulting in falling prices. This deflationary pressure, compounded by collapsing asset price bubbles, will inevitably bring about a crash in both investment and consumption on a worldwide scale that leaves only enormous excess capacity and unpaid debt in its wake.

— Richard Duncan, *The Dollar Crisis*, 2003

THE NEW TREND

This was supposed to be the year of strong global economic growth, low inflation, booming profits and equity prices, technology's recovery, China's boom and a turnaround in Japan. Rarely have forecasts and their underlying assumptions been so quickly discredited.

In its *World Economic Outlook*, published in April 2004, the International Monetary Fund wrote: *"While a recovery now appears to be under way, its pace and nature vary significantly. To date, the upturn is most rapid in emerging Asia, particularly China, and the United States; it is least well established in the euro area, where consumption remains weak and some forward-looking indicators have fallen back or moved sideways in recent months."*

The U.S. Federal Reserve raised its pivotal fed funds rate by the lowest possible minimum of 0.25% to 1.25%, just as almost everybody had expected. What is the difference to the prior rate? In terms of policy stance, none really, and we think that is common knowledge, both in the Fed and in the markets. Considering the recent acceleration of inflation rates, real interest rates have actually declined.

Monetary policy in the United States remains excessively loose, just as before. Fed Chairman Alan Greenspan has done what he has been doing for years: Duping markets and people with apparently sophisticated talk that camouflages his desperation and determination to avoid or prevent the slightest restraint to the rampant credit expansion in the economy. All he wants to do is demonstrate his anti-inflation vigilance, more in words than in action.

What is far less clear, however, is how high interest rates will go — short-term rates set by the Federal Reserve on the one hand and long-term rates set by the markets on the other. It appears to be the dominant school of thought that the post-bubble crisis of the U.S. economy is over, as past aggressive monetary and fiscal policies have rendered a solid, sustainable recovery.

In this environment, according to the consensus view, the Fed can start moving rates to a more "normal" level. Given a current headline U.S. inflation rate of 3.1%, but a core rate of 1.7%, there has been a lot of talk that a "normal" short-term rate is somewhere between 3.75% and 5%.

In our view, these assumptions about the U.S. economy's impending return to "normal" interest rates reveal an unbelievable ignorance and complacency about the economy's underlying health, strength and financial stability. We vehemently disagree with every single thought in this complacent perception.

First of all, we do not see that the U.S. bubble problems have been solved at all. Rather, the asset bubbles — stocks, bonds and mortgage refinancing — that have been crucial in fueling the consumer borrowing-and-spending spree have badly faltered, even though credit excess continued to run amok in the first quarter of 2004. Any meaningful rate hike would definitely burst these bubbles and send the U.S. financial markets crashing.

And *second*, we also do not share the view that the aggressive policies have rendered a truly solid, sustained economic recovery in the United States. An unusually rapid reduction in interest rates to 45-year lows and some unusually drastic tax cuts enabled the American consumer a borrowing-and-spending binge of unprecedented scale. It is a kind of spending that, in our view, essentially makes deceptive economic strength.

For sure, this prevented a deeper recession in the short run, but in essence these policies were nothing more than a palliative that merely aggravated the imbalances in the economy and the financial system that are impairing economic growth in the longer run.

Economic health and strength has two measures: *first*, changes in the level of real national output (quantity), and *second*, changes in the composition of national output (quality). American policymakers and economists in their great majority pay virtually no attention to changes of the latter kind and their consequences.

THE TRUTH: AMERICA'S WORST POSTWAR PERFORMANCE

Emphasizing the mildness of the recession in 2001, America's bullish consensus has nurtured a general perception that the aggressive policies fighting the economic downturn have been a great success. But comparing this recession to others only conveys a grossly distorted picture. Decisive for the economy's future performance is, of course, what happens during the two to three years following the recession.

Manifestly, it is not the recession, but the strength and the pattern or composition of the ensuing recovery that finally determine whether or not the economy has gained sufficient traction for a self-sustaining expansion. The thing to see is that the U.S. economy's performance over the past 30 months since the end of recession in late 2001 has by any measure been its far worst in the whole postwar period.

It looks best by the measure of real GDP growth, yet even this aggregate grossly lags the postwar average. Perspective is key in understanding the unique character of the recent and current economic development in the United States. During the postwar period, real GDP growth has averaged 5.2% during the first two years after recession. For 2002–03, the annual average was a mere 2.7%.

That is a dismal comparison. An unprecedented, unmitigated disaster, however, has been the employment performance. Actually, it is the most disastrous in the world. It turns out that private nonfarm payrolls have virtually gained nothing from their level reached at the trough of the last recession in November 2001.

Normally at this stage in the cycle, the increase is closer to 7.5%. If the current hiring cycle had conformed to the average hiring cycle of the past six upturns, private nonfarm payrolls would be 8 million higher than they are at present, according to Stephen Roach of Morgan Stanley. It is hard to see how an ailing economy can get traction without employment growth.

LOOKING FOR STAYING POWER

Assessing the staying power of an economic upturn, next we examine the quality of its pattern or composition. In its past recoveries, the U.S. economy has always been firing on all cylinders, propelled by surging demand components across the board. The regular spark plugs, triggered by monetary easing, were fixed investment, both residential and nonresidential, and consumer durables, all of them credit financed.

To give an idea of the typical pattern of past U.S. cyclical recoveries, during the first two years of economic recovery after recession, business fixed investment grew at an average annual rate of 6.9%, and that of producers' equipment 9.4%. Residential construction rose 13.2% per year. Overall personal consumption increased 5.1% per annum, moving largely in lock step with real GDP growth of 5.3%.

It used to be a truism among economists that fixed capital outlays play a highly dynamic role in the rise and fall of economic activity, and so in the rise and fall of the volume of goods and services produced (gross national product). In economic life, everything depends on everything else. While true, this statement is not very meaningful. It is the decisive task of macroeconomic analysis to identify those variables in the economic process that are crucially important for economic growth.

What went wrong in the United States? It is, actually, the one country in the world where policymakers and economists regard personal consumption as the decisive demand component for economic growth. Changes in retail sales find the greatest attention. In this view, decreases in business investment follow increases or decreases in consumer spending. In this model, investment is "derived" demand.

Unfortunately, this view goes flatly against decades of empirical evidence. Recessions around the world, and also in the United States, have always begun with a decline in capital spending, and the one striking phenomenon of the present U.S. economic sluggishness is certainly that it started with plunging business investment, while consumer spending was well maintained.

The all-important thing to see is that the protracted consumer borrowing-and-spending binge of the past few years has miserably failed to stimulate the desired and necessary broad investment recovery that is indispensable for a self-sustaining recovery.

This brings us back to the question we posed earlier about the "quality" of the 2000–2003 U.S. economic recovery. What has been its pattern of composition between consumption and investment and other demand components during the past two recovery years? In short, there is no similarity whatsoever with past recoveries, as described above. Though ill patterned in the extreme, nobody noticed.

For the two years as a whole, 86.7% of the recorded real GDP growth of $531.4 billion came from consumer spending and 24.3% from government spending. While business fixed investment recovered during 2003, it was down $51.3 billion for the two years as a whole. The trade balance swallowed $111 billion of the increase in domestic spending.

Frankly speaking, this is a pattern of economic growth at its worst. For any reasonable observer, this is definitely not a pattern that could possibly provide the necessary traction for a self-sustaining and even strengthening expansion. Mistaking strong U.S. GDP growth in the second half of 2003 for economic health and strength, the world economic community simply extrapolated it.

Focusing on the sickly pattern of growth and the growing financial imbalances and structural distortions in the U.S. economy, we believed the generally trumpeted recovery was stillborn. The manifest key variable of the economy has been and remained until the end of last year the consumer borrowing-and-spending binge.

A SURPRISE: HIGHER SAVING

Considering these facts, forecasting the outlook for the global economy in general and the U.S. economy in particular apparently hinges on the estimate of the timing of one single event. That is the timing of when and how fast the U.S. mortgage refinancing bubble will peter out.

For two years, it was the most important prop to consumer spending and U.S. economic growth. The Mortgage Bankers Association refinancing index has plummeted from 9,978 a little over a year ago to 1,387 recently, a decline of 86%. Surprised and pleased by more and more disappointing economic data, investors have stampeded back into bonds, shaving the 10-year Treasury yield by about 40 basis points, back to 4.4%.

Seeing far more disappointing data still to come, we do not exclude a possible moderate further decline of long-term rates. Whether it will go so far as to revive the mortgage refinancing bubble is another question. We think the very bad economic news that is driving longer-term interest rates lower will not fail to temper the general urge for borrowing. Instead, savings may rise. In fact, that is what is happening.

But what is the main cause of this sudden proliferation of weakening U.S. economic data taking the whole world completely by surprise? As we have pointed out in the last two letters, unrealized by most observers, since January the American consumer has suddenly drastically retrenched his spending.

During the first quarter, his spending on goods and services went up $46.8 billion, or 0.6%, compared to an increase by $97.1 billion, or 1.3%, in the fourth quarter of 2003. That represents a pretty drastic retrenchment, we would say.

It is generally agreed that the consumer's behavior over the next few months will be the key factor in determining whether the U.S. expansion will survive or abort. Reading nothing but euphoric reports, we wonder where most people have had their eyes for the past couple of months.

Consumer spending in April was terrible, in particular for the auto industry. Inventories soared to levels not seen in a decade. In real terms, overall spending was just flat. In May, new, big promotions and rebates by the automakers boosted sales sharply. In the absence of any pent-up demand, however, auto and truck sales fell even faster again in June. Inventories soared back to new highs. It has, actually, become the regular pattern of these promotions that initial gains in sales are promptly followed by even bigger declines in sales.

The fact is that for the first time in many years the spendthrift American consumer has truly retrenched. During the first five months of 2004, his disposable income rose $271.8 billion. Yet he increased his spending by only $215.3 billion.

What happened to the difference of $56.5 billion? By definition, that is saving from current income. Actually, since last December, the personal savings ratio has risen from 1.6% to 2.2% of his disposable income. Hardly noticed by anybody, the consumer has resumed saving. While this may seem a minimal increase, this small change in the percentage of the savings rate yet runs into a considerable amount because it relates to total disposable income of $8,672.9 billion most recently.

Focusing instead on the changes in current income and current spending, the economic effect implicit to this rise in savings proves quite formidable. Actually, it diverted fully 20% of the $271.8 billion by which current disposable income grew from spending into saving. This 20% may be called the marginal savings rate.

These are the hard facts concerning the sudden weakness in consumer spending. Considering that it has now lasted fully six months, it seems reasonable to regard it as a newly established trend. For comparison: In 2003, private households increased their spending by $369 billion, while their disposable income rose $359.3 billion.

MORTGAGE REFINANCING: THE PARTY IS OVER

Yet what is the explanation for these hard facts that have taken the whole world completely by surprise? By the way, it was not tight money that induced the consumer to his sudden retrenchment in the first quarter. Paradoxically, while he increased his savings, he beat a new record in borrowing, to the tune of $1,008.2 billion at annual rate. According to mutual fund statistics, he put a lot of that money into these funds.

Well, the stock market is behaving very differently from what had been expected. Measured by the indexes, losses during the year so far are moderate. But there are hundreds of shares on which their owners have suffered very painful losses. Investors might have become a bit risk averse. Also, we think that the mortgage-refinancing activity and equity extraction are for various reasons slowing sharply. In the quarters ahead, growth of consumer spending will have to rely on the growth of personal income.

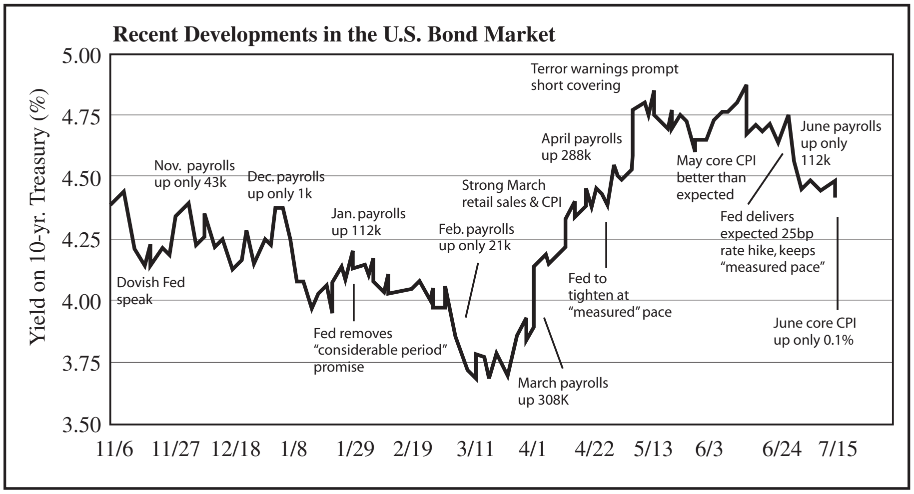
American policymakers and economists have joined in embracing the miracle of a bubble economy. Remember, a bubble economy is by definition an economy in which cheap and loose money primarily inflates asset prices. These, in turn, fuel an additional borrowing binge for higher spending. In the U.S. case, the asset bubble has been centered in property, and the spending bubble in consumption. The infallible hallmark of all such bubbles is runaway credit creation.

Asset price bubbles, showing extraordinary rises in asset prices, have become a regular feature in the world economy since the early 1980s. They generally take place in two asset classes: stocks and property. It is furthermore a historical fact that every single asset price bubble has ended in a painful bust.

In its *World Economic Outlook* of April 2003, the International Monetary Fund reviewed the experience with asset price busts in industrial countries in the postwar period under the title "When Bubbles Burst." The essay finds *"that equity price busts occurred on average every 13 years, lasted for 2 1/2 years and were associated with GDP losses of about 4% of GDP. Housing price busts were less frequent, but lasted nearly twice as long and were associated with output losses that were twice as large, reflecting greater effects on consumption and banking systems, which are typically heavily exposed to real estate."*

For good reasons, asset price busts are the nightmares of policymakers around the world. The rare exceptions are today's American policymakers. Far from worrying, they have been hailing the soaring stock and house prices in the United States during recent years as desirable and healthy wealth creation, enabling private households to maintain their spending despite heavy income losses. What exactly is driving house prices higher appears to be of no interest to them.

Every asset-credit bubble essentially ends in a bust. The crux with them is that in order to maintain their effects on the economy, they must inflate indefinitely. In the case of the U.S. mortgage refinancing bubble, this would require that long-term interest rates make ever-new lows. In fact, they have come down again from their highs in May, but they remain far above their earlier lows.



Key to the U.S. economy's recovery were huge "wealth effects" from rising asset prices. While the various asset bubbles that fostered the consumer's spending spree in bonds, stocks, housing and mortgage refinancing have not burst, they have stopped growing. The wealth effect of still-rising house prices falls flat without the mortgage refinancing bubble. For sure, this was the single most important influence on consumer spending and economic growth.

Reminiscent of the late-'90s manic stock market environment, the question of whether or not housing in the United States is a bubble has become a hot topic for newsletter writers, journalists, policymakers and investment analysts. By the way, the Bank of England, facing exactly the same problem, keeps raising interest rates and warning of a dangerous bubble.

A recently published research paper from the Federal Reserve Bank of New York, on the other hand, strikingly proves that the Fed has made no progress in comprehending or addressing bubble dynamics. From the report: *"Our analysis of both cash flow affordability and a simple asset valuation model suggests that, given the steep decline in interest rates, home prices do not appear to be at unusually high levels. Moreover, the housing market does not appear to be driven by expectation of rapid future price appreciation."*

Measuring the protracted rise in house prices against the rock-bottom U.S. interest rates of recent years is truly a hair-raising verdict, because these low interest rates have come about through massive Fed manipulation, including an unlimited supply of credit. Capital value is current income capitalized at the current interest rate. All it needs to raise capital values is to peg interest rates at artificially low levels. That is plainly what the Federal Reserve has been doing in massive force.

IT LOOKS LIKE A TREND

In the last letter, we mentioned we were eagerly awaiting the May numbers about consumer income and outlays. At first look, these appear excellent: Incomes are up 0.6%, and spending is up even a full percentage point. At second look, after inflation adjustment, the reality is pretty ugly.

The increase in disposable income melts to less than 0.1% in real terms, and that of spending to 0.4%, of which well over half came from the burst in motor vehicle promotion. Spending on nondurable goods has been flat for two months. The whole of the further increase accrued from a blip in spending on services.

Amazingly, this sharp slowdown in consumer spending, though meanwhile going on for half a year, has been meeting flat denial all around. During the five months until May, it was up in real terms $78 billion, or $186 billion

annualized. This is less than half of its growth in the second half of last year — $376 billion annualized. Meanwhile, we know that June was another horrible month for consumer spending.

One main reason for this general indifference to this drastic reversal in consumer spending was apparently the fabulous job figures for the three months March–May that the Bureau of Labor Statistics (BLS) all of a sudden pulled out of its hat, reporting almost 1 million new jobs during these three months.

It shocked us to see how readily and uncritically research institutions, economists and media around the world accepted these numbers at face value, even though they came like a bolt from the blue in the face of otherwise rather mixed economic data. For the few who wanted to see, these numbers were bluntly suspect.

It turned out that virtually two-thirds of the new jobs had come not from the survey, but from a new computer model. For decades, the BLS has aimed at measuring job creation in times of recovery at small businesses not captured by its established monthly survey. Until 2000, this statistical adjustment was fixed at 35,000 each month, called the "plug factor."

The recent sudden jump in these figures towards 300,000 each month results from a computer model based on a calculated "net birth/death adjustment," which is supposed to measure how many jobs small firms have created and shuttered. In this way, the former monthly 35,000 figure exploded into numbers that are almost 10 times greater.

For us, the sudden statistical spike in job creation during March–May was far too much out of whack with prior numbers and other concurrent economic data to be credible. Then came June: 112,000 new jobs created, less than half the expected number. We never saw it mentioned that the net birth/death adjustment contributed 182,000 to this disappointing increase. Without it, employment would have fallen 70,000.

What all this means for the U.S. economy's prospects should be clear: The suddenly strong support from job and income growth looks very much like a mirage. To the contrary, sharply slower consumer spending is essentially exerting the opposite effect of depressing income growth.

What, then, induced the American consumer to his sudden retrenchment in spending in the first quarter? Partly due to lower taxes, his nominal disposable income grew during the quarter by $171.7 billion. Yet he raised his spending by only $119 billion, putting fully $52.7 billion of his higher earnings into savings. That was definitely a drastic break with his past spending mania.

The salient point here is that the retrenchment was plainly not forced by tight money or credit. Oddly, consumer borrowing set a new record at the same time with an increase by $1,008.2 billion at annual rate, after "only" $659.9 billion in the prior fourth quarter of 2003. We have a hard time making sense of this mixture of income growth, savings growth and record borrowing.

The answer probably lies largely in the fact that the "average" private household is a statistical fiction. The other day we read that nearly a quarter of households have to spend 40% of their current income on debt service, as against 14% on average. On the other hand, there are, of course, many households with net income from assets after debt service. Higher bond yields and mortgage rates speak, in any case, for sharply lower borrowing in the future.

In April, an increase in nominal disposable household income by $52.3 billion compared with an increase in their spending by a mere $16.3 billion. In real terms, spending even declined slightly. No less than $36 billion went

REAL PERSONAL CONSUMPTION EXPENDITURES
CHANGE FROM PRECEDING PERIOD IN BILLIONS OF CHAINED (2000) DOLLARS

	OCT '03	NOV '03	DEC '03	JAN '04	FEB '04	MAR '04	APR '04	MAY '04
TOTAL	5.5	51.2	40.4	8.3	13.2	25.3	–1.5	32.7
DURABLE GOODS	–16.7	9.8	28.3	–40.9	6.5	12.8	–5.9	17.8
NONDURABLE GOODS	13.1	27.1	1.7	23.5	–.2	7.8	–3.8	2.0
SERVICES	6.6	15.5	14.0	19.1	7.5	6.5	7.0	15.2

SOURCE: DEPARTMENT OF COMMERCE, *PERSONAL INCOME AND OUTLAYS*

into savings. Due to the huge promotions and rebates by the automakers, spending in May was drastically distorted. Purchases of durable goods were up $17.8 billion, accounting for 54% of the total increase. News about auto sales since then has been disastrous.

Glancing over these figures, it strikes the eye that the sudden spending weakness has gripped all sectors of consumption, services and nondurable goods, as well as durable goods.

As mentioned earlier, lesser consumer spending essentially means lesser income growth. If allowed to develop, it implicitly turns into a vicious circle where lower and lower spending leads to lower and lower incomes. One has to wonder what Mr. Greenspan can come up with next.

In 2001, he had more than 500 basis points of interest rate cuts at his disposal to fight the economy's downturn, led by plunging business investment. Instead, he just raised the Fed funds rate a tiny 0.25%. Our guess has been that very little or nothing will follow. In any case, the thing to see is that monetary stimulus has spent its power — and with miserable results.

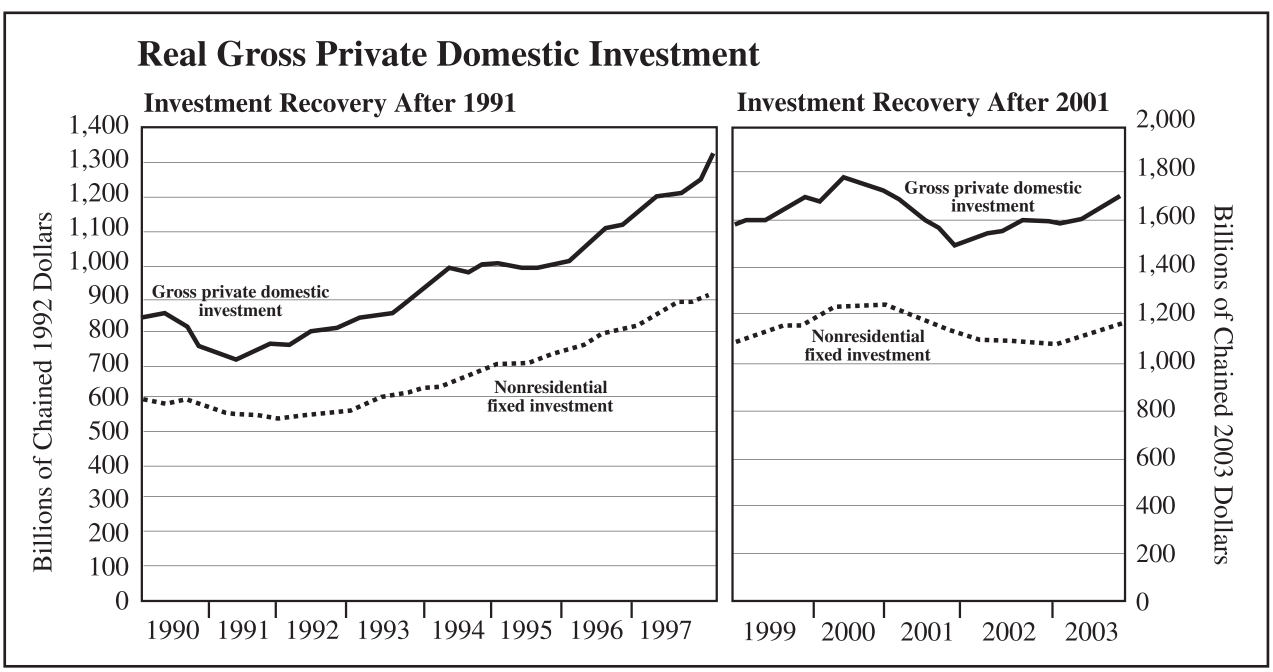
CORPORATIONS TO THE RESCUE?

You would think that in the face of this abrupt consumer spending drop-off alarm bells would be ringing. However, denial and complacency continue to rule. Yet contrary to earlier high-riding expectations, the stock market is the great exception, flatly refusing to play ball. Apparently, most people have yet to realize the severity of the consumption debacle affecting the economy.

At any rate, there is now a general recognition and consensus that a sustained, robust economic recovery will require a major contribution from the business sector in the form of sharply increased hiring and capital investment. The consensus is convinced that corporations, enjoying excellent profits, will oblige.

News of a strong rebound in business investment has been making headlines for quite a while. Yes, there has been such a rebound, but looking more closely, it badly lacks the normal vigor that would be necessary to offset the slowdown in consumer spending. Comparisons with the strength of cyclical investment recoveries in the past make very poor reading.

The following two charts compare the investment recovery after the recession of 2001 with the investment recovery following the 1991 recession, which was typical of the postwar pattern.



To give a few numbers in addition: Over the first two years after recession, growth of real business fixed investment during the postwar period has averaged 13.8%, with producer durables even up 18.8%.

And here are the numbers for 2002–03: Overall nonresidential fixed investment peaked at the end of 2000 at $1,232.1 billion. It hit its low in the first quarter of 2003 at $1,087.3 billion. Over the year, it recovered to $1,186 billion in the first quarter of 2004, still lagging the peak of 2000.

It was by far the weakest investment recovery in the postwar period. What's more, this extraordinary investment weakness had an ominous reason. The recovery took place in a single sector — information high-tech. In the other major sectors, corporate spending on fixed investment went downhill.

In structures, that is, in building new plant, it slumped from $313.2 billion in 2000 to $232.6 billion in the first quarter of 2004. Investment in industrial equipment declined from $159.2 billion to $133 billion. For transportation equipment, it fell steeply from $160.8 billion to $116 billion. (All quarterly numbers are annualized.)

Strictly speaking, there was nothing like a general investment recovery, but an isolated, brief burst in the information high-tech sector, lasting from end-2002 to the first quarter of 2004. Proliferating signs are suggesting that this revival is petering out.

Many tech companies are shocking investors with warnings of much lower revenues and profits than expected. What's more, skyrocketing inventories have become a common feature both in the tech world and in the mainstream economy, plainly indicating that slipping sales are overwhelming optimistic production schedules. In his last issue of *The High-Tech Strategist*, Fred Hickey gave a most impressive list of big buildups in inventories, all measured year over year: Dell, 61%; Cisco Systems, 47%; Foundry Networks, 49%; Texas Instruments, 47%; Sun Microsystems, 25%; Western Digital, 45%; Ericsson, 32%; Lucent Technologies, 14.3%.

Merrill Lynch shocked us with a report that cut the rating on the entire global semiconductor industry from "overweight" to "underweight." It said, *"We believe that the risk of a material downward adjustment in the financial outlook for the semiconductor business is higher now than at any point since early 2002."* The note also cited rapid year-on-year growth in inventories in the first quarter. A new report from Goldman Sachs concluded that the tech recovery *"was stuck in first gear."*

It seems to be now the majority view among industry analysts that the booming chip sales of the last few months will not be sustained. The high levels of inventory carried by manufacturers and trading companies could, of course, accentuate the downturn.

Considering all these facts about business investment spending in general and high-tech investment in particular, there is but one reasonable conclusion: Corporations are not coming to the rescue of the stuttering U.S. economic recovery with a surge in capital spending. If they refused to do so in the last two years, at the height of monetary and fiscal stimulus, it is hard to see why they should do so now in the face of a slowing economy and very little or no hope at all for new demand stimulus.

DENIAL

What, really, is going on in the U.S. economy? What is likely to happen? Consensus opinion has been and remains highly optimistic. It sticks to forecasts of around 4.5% real GDP growth for all of 2004, even though the first quarter slightly disappointed with 3.9% at annual rate.

Next year, growth is expected to slow slightly, yet the consensus remains cheerful. In his recent congressional testimony, Mr. Greenspan predicted gross domestic product growth between 3.5–4% for 2005, confirming the bullish consensus view, while raising the inflation projection to 1.75–2%, from 1–1.25%.

He, in fact, started his testimony with an immediate broadside of extremely optimistic statements:

> *Economic developments in the United States have generally been quite favorable in 2004, lending increasing support to the view that the expansion is self-sustaining. Not only has economic activity quickened, but the expansion has become more broad based and has produced*

notable gains in employment. The evident strengthening in demand that underlies this improved performance doubtless has been a factor contributing to the rise in inflation this year. But inflation also seems to have been boosted by transitory factors such as the surge in energy prices. Those higher prices, by eroding households' disposable income, have accounted for at least some of the observed softness in consumer spending of late, a softness which should prove short lived.

What was so positive about U.S. economic growth in the first quarter of 2004? The following table shows the changes in the contributions of the major demand components to GDP growth between the third quarter of 2003 and the first quarter of 2004.

What these numbers reveal is definitely not an expansion that has "become more broad based," but an expansion that has distinctly lost quality. The contributions from three sectors of key importance for sustained economic growth — nonresidential and residential investment and net exports — have drastically declined. The new strength comes from inventories and government spending. But strongly rising inventories tend to be the precursor of economic downturns.

CONTRIBUTIONS TO REAL U.S. GDP GROWTH IN PERCENTAGE POINTS

	QIII '03	QIV '03	QI '04
PERSONAL CONSUMPTION	4.69	2.29	2.64
NONRESIDENTIAL INVESTMENT	1.25	1.00	0.54
RESIDENTIAL INVESTMENT	1.05	0.40	0.24
INVENTORIES	0.13	0.71	0.65
NET EXPORTS	0.80	–0.32	–0.71
GOVERNMENT SPENDING	0.34	–0.01	0.54

SOURCE: BUREAU OF ECONOMIC ANALYSIS, DEPARTMENT OF COMMERCE

As to consumer spending, it is argued not to overrate its sudden weakness in June, as "one month's data does not make a trend." Yes, but this weakness was not only in June; it is already several months old. According to the numbers of the Commerce Department's *Personal Income and Outlays*, consumer spending over the last few months has been running at an annual rate of less than 2%. This compares with 5%, at annual rate, in the second half of last year.

For at least two months now, each and every early indicator of U.S. economic activity reveals spreading weakness. For the most part, though, all these warning signs are discarded as temporary distortions.

Looking at the numbers in the above table, we always wonder what more evidence American economists need to realize that the U.S. economic recovery of 2002–03 has run out of steam. Though spending is still up, it has been rapidly losing momentum across the board.

We read countless articles explaining many reasons consumer and business investment spending are bound to rise, owing to most favorable conditions, such as booming profits and high cash flows. For all the economic indicators they keep their eyes on, they fail to see the hard fact that investment spending, like consumer spending, is rapidly leaking momentum.

CHEERLEADER GREENSPAN

Our view has always been clear and unambiguous. Ultra-cheap and loose money together with fiscal priming of unprecedented scale have provided a tremendous stimulus to consumer spending in the United States. For the bullish consensus, this policy stance has been most successful, as measured by recent real GDP growth of 4% and higher at annual rates.

For us, this is a much too simplistic and superficial a view. Lost in the celebrations are the long-term costs of this recovery as manifested in the form of ever-mounting structural imbalances — namely record trade gaps, record levels of financial leveraging, record levels of personal indebtedness, a record-high budget deficit and rock-bottom national savings. For any reasonable person, it ought to be clear that this cannot be the road to healthy economic growth.

Altogether, this is a development without precedent. The underlying reason is an unprecedented, drastic change in

the dynamics of American economic growth from income-driven to asset-driven. The worsening imbalances are plainly the outgrowth of a radical shift in the Fed's policy stance toward demand stimulation through asset price bubbles.

It was always the general great hope that strong consumer spending would spark higher business investment and employment growth. There was a brief burst in the third quarter of last year with an annualized growth rate of 12.8%. But that was down to 5.3%, at annual rate, in the first quarter of 2004.

All of the increase in business investment, as earlier mentioned, was in information high-tech.

Yet it apparently did not meet high-riding expectations. All of a sudden, more and more hardware and, in particular, software companies are warning of slowing sales, depressing the Nasdaq index.

In short, U.S. economic growth is manifestly heading sharply downward both in consumption and business investment. We wonder whether strong inventory building may have bolstered GDP growth in the second quarter. The fact is that business inventories are presently at their record level prior to the start of the 2000 downturn.

How to reconcile all this with Mr. Greenspan's rosy description of the U.S. economy's health and performance, quoted above? His key message about 2004 was, *"Not only has economic activity quickened, but the expansion has become more broad based and has produced notable gains in employment."* Answering questions, he explicitly asserted that the softness in U.S. economic data in recent months would prove *"transitory."*

Blatantly, economic activity has neither quickened nor broadened so far in 2004. It has drastically slowed. As to the "*notable gains in employment*," they owe their existence, certainly well known to Mr. Greenspan, not to true counting, but to the BLS's obscure estimate of a net birth/death ratio. These estimates are grossly at variance with the weakening economy.

PROFITS IN DECLINE

Without any doubt, Mr. Greenspan knows about the weakness in the economy. We suspect, however, he believes in his magic to act as the economy's cheerleader. He certainly is a great believer in the role of expectations as determinants of economic activity and the possibilities to influence them in a desired direction.

In contrast, we are great believers in a remark by economist Joseph Schumpeter about the role of expectations: *"No great crisis has ever come about that was not fully explainable by the objective facts of the situation. Expectation not so conditioned never has produced more than short-lived spurts or breaks."*

It has to be noted, though, that Mr. Greenspan recognized the economic downturns both of 1991 and 2000 only after they had started. On July 20, 2000, he said in a testimony before Congress: *"Early in the expansion… we kept rates unusually low for an extended period, when financial sector fragility held back the recovery. Most recently, we have needed to raise rates… in response to the side effects of accelerating growth and related demand-supply imbalances. Variations in the stance of policy… are made in the framework of an unchanged objective — to foster as best we can those financial conditions most likely to promote sustained economic expansion."*

In the very quarter he said this, U.S. real GDP growth plummeted to minus 0.5%, from 6.4% in the prior quarter. He had not revealed the faintest inkling of the collapsing growth. By the way, the whole of this plunge came from business fixed investment and massive inventory liquidation, together down 40%, while consumption continued to increase.

A first round of the unwinding of the carry trade took place in April and May. It boosted the long-term rate by close to 1 percentage point. Yet despite all the talk about unwinding, this was only the tip of the iceberg. Outstanding positions are still enormous. More unwinding will further raise longer-term interest rates, no matter how weak the economy is.

Back to the present. As to sentiment, it seems that the proliferating disappointing news about the economy and corporate profits are gradually eroding the earlier optimism. Yet the possibility of an impending serious economic downturn in the United States appears to be generally still unthinkable.

Significantly, the stock market, widely regarded as the U.S. economy's bellwether, has gone from almost six months of protracted stalemate to a more pronounced glide. But what really explains the U.S. stock market's poor

performance this year? The general, comforting explanation is the usual temporary summer doldrums.

For us, the true reasons are strikingly obvious: mostly disappointing economic news and a distinct crack in corporate profits. Daily, it is profit jitters in the market. Their downturn is already reality. Corporations in the nonfinancial sector earned $409.9 billion in the first quarter, down from $453.3 billion in the prior quarter. Manufacturing profits were $98.8 billion, after $121.1 billion. (All numbers are at annual rates.)

Profits have declined across the board. Compared to a year ago, overall nonfinancial profits are up 10.7%, manifestly much less than the stock market. The general perception of stellar profit growth in 2003 rests partly on the familiar statistical illusion from a very low base.

WHAT ABOUT INFLATION?

In his congressional testimony, Mr. Greenspan explicitly stated the Fed's policy intentions: *"With the growth of aggregate demand looking more sustainable and with employment expanding broadly, the considerable monetary accommodation put in place starting in 2001 is becoming increasingly unnecessary… Policymakers reiterated that, based on our present outlook, the removal of accommodation would likely proceed at a moderate pace. But in light of the considerable uncertainty surrounding the anticipated evolution of price pressures, the FOMC emphasized that it will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."*

These, too, are strong words. Yet what he says about intended actual measures could not have been more cautious and vague. Even if increased as projected, the fed funds rate would still be at a ridiculously low level for an economy supposedly in a strong recovery. The last thing Mr. Greenspan wants is true credit tightening.

America's inflation problems start for us with the appreciation that over the 13 quarters since 2000, the U.S. economy has experienced the world's greatest credit excess in history. Financial and nonfinancial credit during this period grew by $7,592.4 billion altogether, or 28.7%.

What is the true criterion of inflationary credit excess, asked economist John Keynes. His answer: It lies in the preservation of a balance between the supply of savings and the demand for credit. Savings from current income provides the financial and real resources that others borrow for their spending. This insight used to be a truism among economists, Americans included.

In other words, credit expansion should not exceed available national savings. Over those 13 quarters since 2000 mentioned above, U.S. national savings amounted to $209.3 billion. In 2003, they were minus $199.6 billion. Another customary measure of credit excess is the relationship to growth of domestic product (GDP). That grew during these years by $1,634.2 billion. Each dollar added to GDP thus implied $4.60 added to overall indebtedness. Manifestly, this is a financial system where the central bank has abolished any credit restraint.

Mr. Greenspan prides himself to have brought consumer and producer price inflation sharply down. Considering the preposterous credit excess that he allowed and fostered, it is an absurd claim. There were three obvious other reasons for these low inflation rates:

First, a very large part of the preposterous credit excess went into the asset markets, fueling hyperinflation there; *second*, through its galloping trade gap, America has been buying deflation from China and emerging Asia; and *third*, due to unusual methodological practices — heavy hedonic pricing, for example — U.S. rates of consumer and producer price inflation are grossly understated.

CONCLUSIONS:

Focusing on the enormous imbalances and structural distortions in the U.S. economy, its generally trumpeted, sustained recovery was stillborn from the start. Inflating asset prices, propelled by a limitless supply of credit at Fed-orchestrated, "pegged" rock-bottom interest rates, created a deceptive recovery through a protracted consumer borrowing-and-spending binge. There was no break with the dismal saving-investment pattern.

Speaking of rate hikes, Mr. Greenspan is soft in words and even softer in action. For sure, he has not the slightest

intention to impose true credit restraint. Nevertheless, consumer credit has been drastically tightened, not through the Fed, but through the bond market. The rise in yields of 10-year Treasury bonds has driven mortgage rates to a level where they act as a drastic brake on new mortgage borrowing.

Consumer spending has sharply weakened, and the expected strong and broad rebound in business investment never materialized. Contrary to Mr. Greenspan's reassuring testimony to Congress, there should be no doubt that the economic weakness is a new trend, and not a brief blip.

For two or three months already, economic news across the board is weaker than expected. Nevertheless, the markets, particularly the currency market, are trading on Greenspan's credibility, rather than on the flow of weak economic data.

Our main consideration about the U.S. economy's prospects is that the asset and credit bubbles have exhausted their economic impetus. In order to sustain bubble-driven spending, asset bubbles have to be kept inflating. That's America's new biggest problem.

Though they have lost their economic impetus, the bubbles still exist, and that is America's other new big problem. It lies in the fact that the highly leveraged bond carry trade is unsustainable in the long run. Further modest rises in the long-term rate would prick it. Consider that with leverage of 20-to-1, a 5% fall in bond prices, reflecting an increase in rates by just 50 basis points in 10-year bond yields, would wipe out 100% of investor equity.

But there is only one way to forestall this tremendous looming risk, and that is to sell the bonds held in carry trade. Essentially, the highly leveraged carry traders are on edge to sell whenever the market situation allows. For us, this guarantees that U.S. long-term interest rates have a long way to rise, even if the economy weakens. The counterparts to absorb the potential massive selling of bonds simply do not exist.

At some point in the very near future there will be a sea change in the outlook for the U.S. economy. The shock of recognition will rock its asset markets.

The reported weak GDP growth in the second quarter was centered in consumer spending. Its growth rate plunged to 1%, from 4.1% in the prior quarter (both numbers annualized). Again, the weakness was across all three components: durable goods, minus 2.6% after +2.2%; nondurable goods, minus 0.1%, after +6.7%; and services +2.6% after +3.3%.

Actually, consumer spending rose in real terms by a mere $19.5 billion, an increase by $76.2 billion in the prior quarter. That is a virtual collapse in comparison to the earlier spending levels in 2002–03. Its cause is, of course, the next most important question. There were no great changes in disposable income. In chained dollars, its growth rate slowed to 2.9% from 3.2% in the prior quarter. Income from wages and salaries in the private sector made only a minimal gain, despite the reported record gains in employment.

What, then, was the main culprit of this drastic curb in consumer spending? Sharply higher personal saving! It shot up to $142 billion, up from $103.4 billion in the prior quarter and an incredible $79.5 billion year-over-year.

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